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Indian growth veils double deficit pitfalls

By Kunal Kumar Kundu

With the union budget of India slated to be released on February 28, Finance Minister Pranab Mukherjee will be in a much happier frame of mind than he was during the presentation of the previous budget. This has mostly to do with the current state of government finances. The following table indicates why:

	Budget Estimates FY 2010-11 (Rs. Bn)	Actuals (Apr-Dec, 2010) (Rs. Bn)	% of Actuals to Budget Estimates	
			Current	COPPY*
Total Receipts	7273.41	5041.65	73.20%	(64.9%)
Tax Revenue (Net)	1481.16	1931.2	130.40%	(58.2%)
Non-Tax Revenue	7273.41	6156.03	84.60%	(64.1%)
Total Expenditure	11087.49	6906.87	71.00%	(69.3%)
Fiscal Deficit	3814.08	1865.22	44.90%	(77.3%)
Revenue Deficit	2765.12	1401.58	42.10%	(88.9%)
Primary Deficit	1327.44	519.78	18.80%	(102.6%)

*Note: * - Corresponding period of previous year.*
Source: Controller General of Accounts

India's fiscal deficit for the first nine months is only 44.9% of budget estimates, while it was 77.3% in the previous year. The situation is similar to the revenue deficit and the primary deficit, both of which are substantially lower than in the previous year - despite total expenditure being relatively higher at this point.

Two important developments account for this healthy situation. One is positive – greater tax buoyancy; the other is fortuitous - windfall revenue generated through the auction last year of the telecommunications spectrum. It is important to note here that the revenue generated through the auction was more than 1,000 billion rupees (US$22 billion).

Without that, the deficit scenario might not have been too rosy.

The bigger problem, however, is the deficit itself - or rather, its constituents. In a report, "The Future of Public Debt: Prospects and Implications," by Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, published by the Bank of International Settlements (or BIS Working Paper No 300), there is a discussion of two types of deficit - the cyclical deficit and the structural deficit. "Cyclical deficit" refers to the deficit that increases at the lower end of the business cycle and decreases when the cycle turns around. "Structural deficit", on the other hand, refers to the deficit that shows stickiness across the business cycle.

In the case of India, most of the deficit components are structural in nature. During a high growth period, India has demonstrated the uncanny ability to find expenditures to meet rising income rather than conserve the same for the rainy season. The best example that comes to mind is the debt waiver scheme that was announced in February 2008 and was estimated to cost 600 billion rupees. Did this scheme lead to lower indebtedness? Highly doubtful. Has this scheme reduced incidences of farmer suicides? No. Could this amount have been better utilized? Any day.

Coming to the present, payments under the government's Rural Employment Guarantee Scheme have now been indexed to inflation. Make no mistake, this is a socially desirable scheme. Also, with rising prices, the rural poor have been badly impacted. Going forward, however, this will only increase the leakage apart from the fact that in the age of high inflation expenditure on this scheme will continue to rise.

Then there's the holy grail of Indian politics - subsidies. The oil subsidy remains high. So do the fertilizer and food subsidies. And, once the Food Security Bill comes into force, the impact could be debilitating. As per the estimates of an expert committee headed by Dr C Rangarajan, chairman of the Prime Minister's Economic Advisory Council, the food subsidy will rise to 920.60 billion rupees, which is about 65% higher than the estimated subsidy bill for the current financial year. As this will call for increased procurement of food grains, one can only expect a rise in the Minimum Support Price to achieve this objective and an additional cost of storage of food grains.

Period	Food subsidy (Rs. Bn)
2001-02	174.99
2002-03	241.76
2003-04	251.81
2004-05	257.98
2005-06	230.77
2006-07	240.14
2007-08	313.28
2008-09	437.51
2009-10*	560.02
2010-11*	555.78

*Note: * - estimated. Source: RBI & government sources*

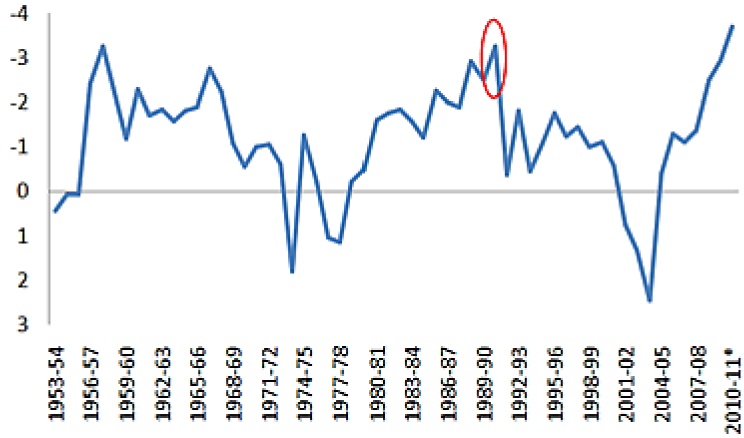
Even the oil subsidy is likely to increase as oil prices continue to remain at a higher trajectory. Currently, the oil subsidy itself is estimated to be close to 750 billion rupees. As the turmoil in North African nations spreads to the Middle East, the situation can worsen. With inflation remaining high, the government will, per force, prefer not to align domestic oil prices with international prices, for fear of further backlash. Thus prices of petroleum products and fertilizers are likely to remain the same, thereby inflicting further damage to the fiscal position.

With regard to the comfortable fiscal situation this year, let us not be under any illusion of successful fiscal management by the government. There's no indication whatsoever about the government's intent to bring a check to its profligate ways - be it through reduction of wasteful expenditure or through administrative reforms to check the huge leakage in the system or through more prudent subsidy schemes. With an unchecked rise in expenditure, the only way the deficit can be under control would be through an increase in receipts. And, that's a big if.

With the 3G auction behind us, the only other source of some one-off revenues would be disinvestment in government entities. Success would depend on an improvement in the overall investment climate. If the climate does not improve, the government will be hamstrung. Thus the hopes of the government must rest on rising tax revenue. Whether tax revenue will remain as buoyant as it is at present remains the moot question.

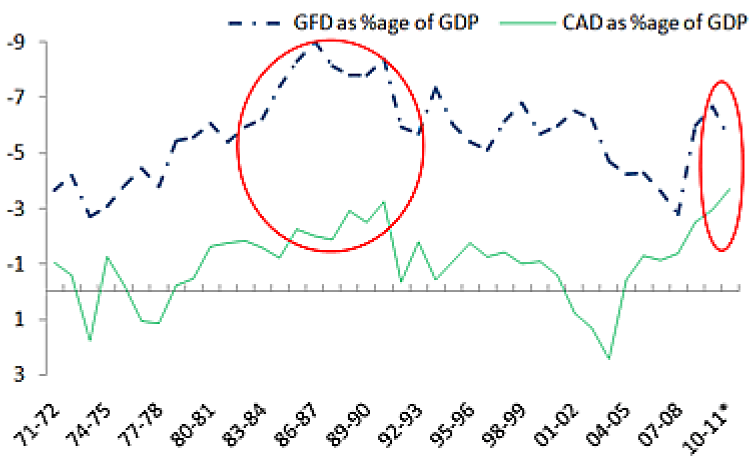
With gross domestic product (GDP) growth expected to be lower next financial year, things definitely do not look so good, more so with the government facing a crisis of confidence in terms of high inflation and corruption at higher levels. I believe that the forthcoming budget will see the government adopting more populist schemes to deflect criticism. This will mean goodbye to fiscal prudence.

Adding further insult to the injury is the return of a high current account deficit (CAD) in India. During the first half of the current financial year, India's current account deficit as a percentage of GDP stood at 3.7%. If the deficit persists at the same level for the rest of the year, it will be the highest recorded, higher even then in 1990-91 when the country went into crisis.



*Note: * - Apr-Sep, 2010. Source: RBI and government sources*

This also marks the return of the twin deficit - that is, a high fiscal deficit along with a high current account deficit.



*Note: * - Budget estimate. Final fiscal deficit would be much lower during 2010-11*
Source: RBI & government sources

The twin deficits of the late 1980s led to the crisis of 1991. Since then, the CAD has remained in a comfortable zone, with occasional forays into positive territory. However, as the global crisis erupted in 2008, global trade went on a tailspin. India's CAD jumped from 1.4% in 2007-08 to 2.5% the next year and close to 3% by 2009-10, driven by high commodity prices, most importantly oil.

The situation is unlikely to alter much in the coming financial year. The problem has been further exacerbated by the contrasting nature of foreign capital flows. While the more stable component, the foreign direct investment (FDI) inflow, remains muted, the inflow of hot money (read foreign institutional investor - or FII - funds) remained strong initially until it showed its true colors and started exiting India at an equally fast pace.

Certainly India is not at present in the throes of crisis. That does not mean high deficit levels should be ignored. Agreed, the recent rise in the fiscal deficit was, to a certain extent, on account of stimulus measures to prop up the economy, but it is time to take a long and hard look at the deficit number to bring it down to manageable levels. If India does not show enough urgency in this regard, the country will have to pay the price through lower growth.

Kunal Kumar Kundu *is Senior Practice Lead, Knowledge Services Division, Infosys Technologies Ltd. The views are those of the author, whose website is* http://kunalsthoughts.weebly.com.